The Blumenthal Viewpoint

August 31, 2011

Fundamentals, Valuations and Charts – Put protection back on now (here's how):

Fundamentals:

The S&P recently hit a low at 1120 and today sits just above 1200. I thought it would be a good time to look at target probabilities based on actual reported earnings and then look at some current charts that confirm a new cyclical bear market. Based on the recent Median PE Ratio of approximately 15, and the most recent 12-Months Actual Reported Earnings of $83.95, we get an estimated valuation of 15 x $83.95 (latest 12-Months Earnings as of 6/30/11) or 1259. That is up from what I reported in February tied to an increase in reported earnings. You can read my letter by clicking here.

Let's look at a probability range based on reported earnings (not future estimates as they are always over optimistic):
A one standard deviation move to the upside puts the S&P 500 at approximately 1600.
A one standard deviation move to the downside puts the S&P 500 at approximately 950.
*Typically a one standard deviation move represents an extreme move.

From an earnings and valuation perspective, its 1600 to the upside (I don't think we get there any time soon) and 950 to the downside (likely if there is a recession in 2012).

From a historic perspective (meaning the average PE over the last 85 years), 1200 on the S&P is not too bad a valuation. It is certainly better than the 40 PE at the beginning of the secular bear in March of 2000; however, keep in mind that secular bears historically end at PE's below 10. Over time, markets move from high valuations to low valuations and back again.

Valuations:

The following chart is a review of the historical statistics on valuation and subsequent 20 year returns (clearly you want to get aggressive at points of low valuation and protective at points of high valuation). There were 90 twenty year periods from 1919 to 2008. The historical performance results tied to PE levels are telling. Simply, valuation matters. If the starting PEwas high, the actual performance return over the next 20 years was low. Conversely if the PE level was low, the actual performance return was high. (Thanks to Crestmont Research for the following chart).

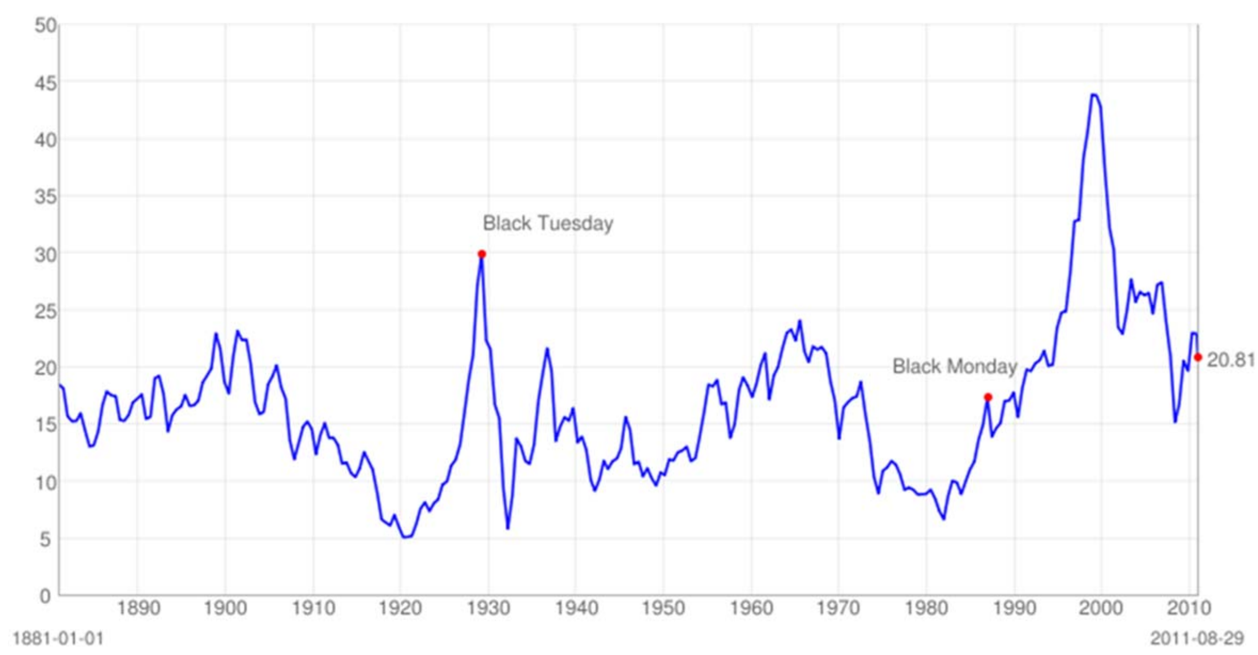
20 Year Periods Ending 1919 - 2008 (90 periods)

DECILE	NET TOTAL RETURNS BY DECILE RANGE FROM	TO	S&P500 DECILE AVG	AVG BEGIN P/E	AVG END P/E
1	1.2%	4.5%	3.2%	19	9
2	4.5%	5.2%	4.9%	18	9
3	5.2%	5.4%	5.3%	12	12
4	5.4%	6.0%	5.6%	13	12
5	6.2%	7.9%	7.0%	15	15
6	8.0%	9.0%	8.6%	16	19
7	9.0%	9.6%	9.3%	15	19
8	9.7%	11.0%	10.4%	11	20
9	11.5%	11.9%	11.7%	12	22
10	12.1%	15.0%	13.4%	10	29

Note: P/E ratio based upon Shiller methodology

The next chart is the recent Shiller PE. Shiller takes a different look at PE. This is different from the Medium PE. The idea here is to look at Shiller PE relative to the 90 twenty year rolling periods. At a reading of 20.81, the forward potential return over the next 20 years will be challenged. Of course, past performance can not guarantee anything. For me, I don't like the odds from a probability standpoint.

Shiller PE:



<u>Recession:</u>
I believe a recession is highly probable over the next 12 months. The economic picture is ugly.

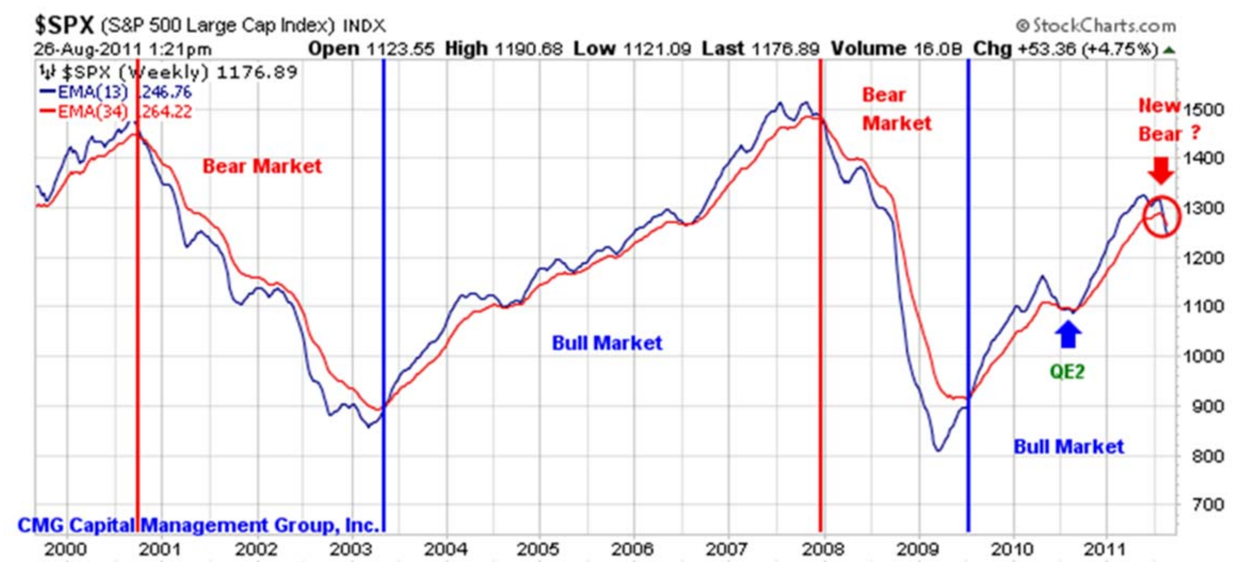
Via Mauldin: "When GDP year-over-year drops by more than 2%, we have always had a recession. So with today's second-quarter revision (first revision of many) down to just 1% (technically 0.99%, but we are among friends here), where are we? At 1.5% year-over-year. Also, the Michigan Consumer Sentiment number was just awful. It dropped 8 full points (which is huge for this index) to 55.7. The index has fallen nearly 20 points in three months.

Since 1945, all recessions have been business-cycle recessions. We are now in a deleveraging/balance-sheet/post-credit-crisis recession for which we have no modern analogs, except maybe Japan. And that hasn't turned out too well, as in, two decades of going nowhere. Yet we are applying the same methodology (massive debt and deficits along with zero interest rates) that did not work there, and will soon bring Japan to ruin. We have a fundamentally different economic scenario than at any time for the last 66 years. Why then should we expect the same outcome? EVERY indicator (employment, GDP, ISM, sentiment, etc.) is far below its average result two years after the official end of a recession. That should speak volumes."

Earnings closely correlate to GDP growth over time. It is a slow growth, world-wide deleveraging environment.

Remember that the average correction within a recession is between -30% to -40%. The S&P is down 12.40% from the high of 1370. I believe a recession in 2012 has a high probablity. Thus my belief that portfolio protection on the long, "buy-and-hold" equity component of your portfolio is important. To be clear, there is no need to hedge the Tactical/Alternative portion of your portfolio. Those allocations typically trade the market trends whether they be up or down or they raise cash. They should be non-correlating to the broader markets, thus the important role within a diversified portfolio.

<u>Technicals – Confirmed Cyclical Bear within the context of an existing Long-Term Secular Bear:</u>
The following is a weekly chart on the S&P 500 index going back to the beginning of the secular bear market in 2000. It is one of my favorate intermediate-trend charts. It simply looks at the 13 week Exponential Moving Average ("EMA") compared to the 34 week EMA. When the 13 week crosses the 34 week, a change in trend is confirmed. It has effectively called the bull and the bear market moves over the last 11 years. Look at the sell signal in 2000 and again in late 2007. This indicator is not to be ignored.



I said in my April 29, 2011 letter that the average cyclical bull move within a longer-term secular bear is 26 weeks. That targeted a May 2011 cyclical Bull market high. That high remains in place.

The following chart looks at bollinger bands. Note that bull market moves bump along the upper end of the band and bear market moves bump along the lower line. Note also that the middle line marks support in bull markets and overhead resistance in bear markets.

I have boxed in red the current trading range. I again recommend putting portfolio protection on the long-term equity component of your portfolio between 1200 and 1250. The market is working off a very aggressive oversold condition and we are seeing a bounce. Technically, the 1250 area is strong resistance.

Two Hedge ideas on a hypothetical $100,000 of long equity allocation:

1. Write Covered IWM Calls and Buy Out of the Money IWM Put Options – For example, the IWM (Russell 2000 iShare ETF) is currently at 73.25. Sell the October 78 calls at approximately $1.50 and buy the October 68 puts at approximately $2.30.

You collect $1.50 and you spend $2.30 for a net cost of $0.80 per contract. Your risk is two fold. A) the market keeps on moving higher between now and the 22nd of October and rises above 78. The roughly 3% of your portfolio of stock that you have pledged against the covered call may get called away from you causing a capital gain on those shares. However, the additional market gain of 6% (the move from from 73.5 to 78) will be yours and you can always buy those positions back. If IWM closes below 78 between now and October 22nd, you keep the full $1.50. Assess the probabilites of a move above 78.

The October 68 puts give you the right to sell IWM at 68 between now and October 22. IWM hit a low of 63 last week. It has rallied to 73.5 with next resistance at 74-76. It was as high as 86 in early July. Should IWM decline back to 63 by October 22nd, the 68 puts will move to between $5 and $7.50 per contract depending on when such move occurs.

Rough Math: a net cost of $0.80 grows to approximately $6.25 if IWM falls to 63 within the next 6-7 weeks. If an investor bought 15 October 68 Put Contracts and sold 15 October 78 Covered Call Options, he would make an estimated $10,000 should he cover the positions when IWM hits 63. An inexpensive hedge costing approximately $1,200 or 1.2% of a$100,000 portfolio can protect against a 10% equity market decline.

2. Sell a meaningful portion of you long equity portfolio and buy an inverse IWM ETF at points of optimistic extreme tied to logical resistance levels, then take the hedge off at points of extreme pessimism tied to logical support levels. The symbol for the short Russell 2000 ProShares ETF is RWM. The 2x short Ultra Short Russell 2000 ETF symbol is TWM. The symbol for the Short S&P 500 ProShares ETF is SH. The symbol for the 2x Ultra Short S&P ProShares ETF is SDS. There is important compound interest math for you to understand when using 2x leveraged ETF's. Be careful and read all fund prospectuses. Go to www.ProShares.com for prospectuses and additional information.

Note: Options are risky and require knowledge and experience. This is NOT A SPECIFIC RECOMMENDATION TO BUY OR TRADE OPTIONS as it may not be suitable for you. It is for

education/discussion purposes only. Speak with your financial advisor and note that there are a number of well qualified experts that you can hire to help implament option hedges. And in my opinion, never ever write naked options.

I believe the put and call options give you the greatest leverage. I realize that this may be advanced. Not only does this portfolio management require time, it requires a great deal of discipline, patience, and execution experience. Importantly, I believe that the hedges need only be put in place a few times a year, as I have been identifying in past Blumenthal Viewpoints (April 2011 and August 2011 so far this year).

In this secular bear environment, I like strategically hedging the 30% equity component, carefully managing the 30% fixed income component, and allocating the remaining 40% to Tactical Strategies and other alternatives. When the secular bear ends, the game plan changes (no need to hedge in secular bull markets and a shift in allocation weightings from 30/30/40 to 40/40/20 may be appropriate, but I believe that is a number of years from now). For now, caution and disciplined risk management is paramount.

I am by nature a very optimistic person and my intentions are to reflect the probabilities as I see them moving forward. I've been in the secular bear camp since 1998 (then tied to crazy valuations). After 27 years in the business I've been humbled many times and I'm sure I will be again. There are simply no guarantees. This is a probability game coupled with a traders mind set and disciplined risk management.

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With kindest regards,

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